

# Structure and Functions of the Federal Reserve System

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## Summary

In 1913, Congress created the Federal Reserve System to serve as the central bank for the United States. The Federal Reserve formulates the nation's monetary policy, supervises and regulates banks, and provides a variety of financial services to depository financial institutions and the federal government. The system comprises three major components: the Board of Governors, a network of 12 Federal Reserve Banks, and member banks.

Congress created the Federal Reserve as an independent agency to enable the central bank to carry out its responsibilities protected from excessive political and private pressures. At the same time, by law and practice, the Federal Reserve is accountable to Congress. The seven members of the board are appointed by the President with the advice and consent of the Senate. Congress routinely monitors the Federal Reserve System through formal and informal oversight activities.

This report examines the structure and operations of the major components of the Federal Reserve System and provides an overview of congressional oversight activities. The report identifies the provisions of P.L. 111-203 (the Dodd-Frank Wall Street Reform and Consumer Protection Act) that affect the structure and operations of the system.

This report will be updated as events warrant.

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## Background

The U.S. central banking system was established in 1913 by the Federal Reserve Act (P.L. 63-43). Congress created the Federal Reserve (popularly known as the “Fed”) as an independent entity to attend to the nation’s credit and monetary needs without undue influence from political pressures. Today, the Fed’s monetary policy operations are intended to promote stability in the nation’s economy; its supervisory and regulatory functions are intended to provide a safer, more flexible banking system; and its work as fiscal agent for the government and clearinghouse for private sector financial transactions promotes efficiency in the overall banking system.<sup>1</sup> In keeping with its independence within the federal government, the system operates without appropriations from Congress. Its income derives primarily from interest on government securities acquired through monetary policy operations, and fees for banking services, with any excess income returned to the Treasury.

The current structure of the system has three major components established by the original act. First, a Board of Governors oversees the whole system and has responsibility for monetary policy. Second, there are 12 regional Federal Reserve Banks, which carry out supervision and examination of commercial banks that are Fed members. The member banks, all national banks and all state-chartered banks that choose to be members of the system, make up the third component.

## Board of Governors

The Board of Governors of the Federal Reserve System was established as a federal government agency. The Administration and Congress can have a significant influence on the Fed through control over appointments to the seven-member board. Each of the seven governors is appointed by the President, with the advice and consent of the Senate. The full term of service for a board seat is 14 years and governors may be named to a vacant seat at any point during the term. The appointments are staggered with one term expiring every two years. Governors serving a full term may not be reappointed. Two members hold the leadership positions of chairman and vice chairman of the board.<sup>2</sup> They are designated by the President, with the advice and consent of the Senate. The term of service for both leadership offices is four years; an office holder may be reappointed. These terms do not coincide with that of the President or each other. Although the board chairman is considered quite powerful, each governor has one vote on the board.

When selecting a governor, the President is required by law to give due regard to a fair representation of financial, agricultural, industrial, and commercial interests, and geographical divisions of the country. No more than one governor can be selected from any one Federal Reserve district. The members of the Board of Governors cannot hold any office, position, or employment in any member bank during the time they are in office and for two years after.

The board chairman is Ben S. Bernanke, whose term as chairman ends in January 2014 and whose term as governor expires in 2020. The vice chairman is Janet L. Yellen, whose term as vice chairman expires in October 2014 and whose term as governor ends in 2024.

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<sup>1</sup> For an examination of the policy actions initiated by the Federal Reserve to manage and contain the current financial crisis and further financial stability, see CRS Report RL34427, *Financial Turmoil: Federal Reserve Policy Responses*, by Marc Labonte.

<sup>2</sup>Provisions of P.L. 111-203 add a leadership position, please see the “Congressional Action” section of this report.

## Monetary Policy

A central responsibility of the Board of Governors of the Federal Reserve System is the formulation of monetary policy. In broad terms, monetary policy involves “influencing the monetary and credit conditions in the economy in pursuit of maximum employment, stable prices, and moderate long-term interest rates.”<sup>3</sup> In addition, when the Federal Reserve was established, it was given the role of “lender of last resort” to the nation’s financial system.

The Federal Open Market Committee (FOMC) is the policy making body for open market operations—the principal means through which monetary policy is conducted. The seven board members plus five of the 12 Federal Reserve Bank presidents make up the FOMC. The president of the Federal Reserve Bank of New York (New York Fed) is a permanent member because the New York Fed executes the Federal Reserve’s monetary policy decisions through open market operations. The remaining four seats are filled by the other 11 presidents on a rotating basis for one-year terms. All of the presidents participate in the FOMC meetings and contribute their views, but only the five members vote. The committee elects a chairman and vice chairman. Traditionally, the chairman of the Board of Governors is elected chairman of the FOMC and the New York Fed’s president is elected vice chairman.

Open market operations involve the purchase and sale of government securities in the secondary market by the Federal Reserve. The operations are conducted to keep the federal funds rate close to a target rate that is set by the FOMC. The Federal Reserve System’s portfolio is composed of U.S. Treasury securities, federal agency securities, and bankers acceptances. The Federal Reserve Bank of New York holds the portfolio and through its trading desk conducts open market operations pursuant to directives of the FOMC.

Two less often used monetary policy instruments may be employed by the Federal Reserve—legal reserve requirements and the discount window. Depository financial institutions are required by law to set aside reserves in certain proportions against demand deposits. What is held in reserve affects the availability of loanable funds. An increase in the requirement would mean banks and thrifts would have less money to lend and would tend to restrain credit conditions. Alternatively, lowering the requirement would increase the proportion of deposits that could be lent and would tend to ease credit conditions. Reserve requirements are rarely changed because as a monetary policy tool they are considered too blunt an instrument.

The discount window is the Federal Reserve facility for lending to eligible depository institutions. An institution may borrow funds for short periods from a Federal Reserve Bank to augment its reserve balances for interbank transactions. The discount rate is the interest rate charged for this short-term loan. The rate is set by each Bank subject to approval by the Board of Governors; over time, it has become common practice for the rate to be uniform for all 12 Reserve Banks. A higher rate discourages borrowing and in turn lending by banks and thrifts. Currently, the discount window serves mainly a signaling function that acts as a complement to open market operations.<sup>4</sup>

In response to the financial crisis that emerged in 2007, the Federal Reserve employed several new tools (in addition to the traditional ones) designed to support the liquidity of depository and

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<sup>3</sup> Board of Governors of the Federal Reserve System, *The Federal Reserve System: Purposes and Functions*, p. 1, available at [http://www.federalreserve.gov/pf/pdf/pf\\_1.pdf](http://www.federalreserve.gov/pf/pdf/pf_1.pdf).

<sup>4</sup> For more information on monetary policy, see CRS Report RL30354, *Monetary Policy and the Federal Reserve: Current Policy and Conditions*, by Marc Labonte.

other financial institutions and to foster improved conditions in financial markets.<sup>5</sup> The implementation of these new tools resulted in significant changes to the Federal Reserve's balance sheet. During the crisis, the Federal Reserve used its broad emergency authority under Section 13(3) of the Federal Reserve Act to authorize many actions that targeted parts of the financial system outside of the banking system. The Federal Reserve has stated it will continue to employ its policy tools as necessary to support the economic recovery.<sup>6</sup>

## Supervision and Regulation

The Board of Governors has a broad range of supervisory and regulatory responsibilities that affect the entire U.S. banking system.<sup>7</sup> The board seeks to promote safety and soundness, ensure compliance with laws and regulation, and foster the fair and efficient delivery of services to customers of financial institutions. Federal Reserve Board regulations implement policies set by Congress that are defined in legislation and referred to the Federal Reserve for enforcement. For example, the Fed has implementation and enforcement responsibilities for the Truth in Lending Act, the Electronic Funds Transfer Act, and the Fair Housing Act. The board coordinates its activities with other federal and state regulatory agencies. The board has the power to examine all member banks and their affiliates and to require periodic reports from them.

The board has the primary responsibility for supervising and regulating bank holding companies and state-chartered banks that are members of the Federal Reserve System. In addition, the board supervises corporations through which U.S. banks conduct operations abroad, and the U.S. operations of foreign banks. The board delegates many supervisory duties to the 12 Reserve Banks subject to the board's policy and oversight. An example is the task of conducting bank examinations.

The Board of Governors has broad oversight and supervisory authority over the operations and activities of the Federal Reserve Banks. The board appoints three of the nine directors of each Bank. The board conducts annual financial examinations of the Reserve Banks. Major expenditures, such as building construction, must be approved by the board. The salaries of Reserve Bank presidents and first vice presidents are subject to board approval.

## Federal Reserve Banks

The 12 Federal Reserve Banks carry out the day-to-day operations of the Federal Reserve System. Within each geographic district a city was designated as the location of the Reserve Bank. The act also provided for branch offices to support the operations of the Federal Reserve Banks. The 12 Banks are located in Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, and San Francisco. The Board of Governors has established 25 branches over the years.

Each Federal Reserve Bank is managed by a nine-member board of directors that is divided into three classes: A, B, and C. They serve three-year terms on a staggered basis. The three Class A

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<sup>5</sup> For in depth information on the Federal Reserve's responses to the financial crisis, please see CRS Report RL34427, *Financial Turmoil: Federal Reserve Policy Responses*, by Marc Labonte.

<sup>6</sup> The Federal Reserve has a dedicated section on its website that provides information on monetary policy actions, please see <http://www.federalreserve.gov/monetarypolicy/default.htm>. For information specific to the crisis response click on Credit and Liquidity Programs and the Balance Sheet.

<sup>7</sup> Provisions of P.L. 111-203 expand the supervisory and regulatory responsibilities of the Federal Reserve. Please see the "Congressional Action" section of this report.

and Class B directors are elected by the member banks in each district. Three Class C directors are appointed by the Board of Governors. The three Class A directors represent the interests of the member banks. The remaining six directors represent the general public and are selected with due consideration to the interests of agriculture, commerce, industry, services, labor, and consumers. Class B and C directors cannot be officers, directors or employees of any banking institution. In addition, Class C directors cannot hold stock in a bank or bank holding company. The board designates one Class C director as chairman and another as deputy chairman. Each Reserve Bank is headed by a president nominated by the nine directors subject to the approval of the Board of Governors.<sup>8</sup>

The District Banks are the principal medium through which the general supervisory powers of the Fed are executed. Federal Reserve Banks conduct on-site examinations of state member banks and inspections of bank holding companies and their nonbank subsidiaries.

The Federal Reserve Banks provide fiscal agency and depository services to the federal government. For example, as fiscal agents they issue, transfer, exchange and redeem government securities and savings bonds. As depositories, they provide transaction accounts for the Treasury and they collect and disburse funds on behalf of the federal government.

The 12 Reserve Banks provide banking services to depository financial institutions. The Banks maintain reserve and clearing accounts for banks and thrifts. The Banks play a major role in the nation's payment system. Reserve Banks move coin and currency into and out of circulation. They also participate in the collection and processing of millions of checks daily. The Banks are an integral part of electronic funds transfer systems, clearing and settling electronically originated credits and debits.

The income of the Federal Reserve Banks is primarily generated from interest on government securities acquired through open market operations. In addition, the Monetary Control Act of 1980 requires the Federal Reserve to charge fees for various services. From their earnings the Reserve Banks pay their operating and other expenses. The Banks are assessed semiannually by the Board of Governors for the board's costs and expenditures. The residual earnings are turned over to the U.S. Treasury. Payments to the Treasury in 2009 totaled \$47.4 billion.<sup>9</sup>

## Member Banks

The Federal Reserve Act requires all national banks to be members of the Federal Reserve System. National banks are banks chartered by the federal government. Membership by state-chartered banks is optional. If state-chartered banks elect to become members they must meet standards set by the Board of Governors. As of June 30, 2009, there were 1,502 national banks and 844 state-chartered Federal Reserve member banks. While these member banks represented only about 34% of all federally insured U.S. banks, they held about 80% of all insured bank assets.<sup>10</sup> The 12 Reserve Banks are "owned" by their member banks. The stock of the Federal Reserve Banks is held entirely by the member banks in their respective districts. Ownership of this stock does not carry the usual rights of control and financial interest ordinarily associated with being a shareholder in a corporation operated for the purpose of making a profit. Each member bank buys stock in its district Reserve Bank equal to 6% of its own capital and surplus.

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<sup>8</sup> Provisions of P.L. 111-203 make a change in the election of Federal Reserve Bank presidents. Please see the "Congressional Action" section of this report.

<sup>9</sup> Federal Reserve Board press release, see <http://www.federalreserve.gov/newsevents/press/other/20100421b.htm>.

<sup>10</sup> U.S. Federal Reserve System, *2009 Annual Report of the Board of Governors of the Federal Reserve System*, June 2010, p. 446.

Of this amount, 3% must be paid-in and 3% is subject to call by the Board of Governors. The stock may not be sold or pledged as security for loans. Dividends are set by law at the rate of 6% per year on paid-in stock.

## **Congressional Oversight**

Throughout the history of the Federal Reserve System, Congress has been concerned with achieving a balance between assuring independence for the system's operations and making the agency accountable for its actions. Attention to Federal Reserve accountability has resulted in increased disclosure by the Fed and dialogue between the Fed and Congress on monetary policy and the agency's operations overall. Avenues of communication and oversight, both formal and informal, have developed over time.

Aside from its appointment role, Congress exercises oversight in a variety of ways. The Federal Banking Agency Audit Act (P.L. 95-320) was enacted in 1978 to enhance congressional oversight responsibilities. The law gave the General Accounting Office (GAO; now the Government Accountability Office) the authority to audit the Board of Governors, the Reserve Banks and branches. Such audits are limited by statute, however.<sup>11</sup> Congressional oversight on these matters is exercised through the requirement for reports and through semi-annual monetary policy hearings, described further below.

## **Reports and Hearings**

The Federal Reserve publishes numerous reports during the year which are important to the oversight work of Congress. The Board of Governors publishes an annual report of activities which includes the minutes of the FOMC meetings. The board is required by law to report annually on compliance with its consumer regulations. The Federal Reserve issues reports and surveys on a variety of subjects, for example an annual survey of bank fees and services and a report on the profitability of credit card operations.

The Fed is frequently called upon to testify on a wide range of issues affecting the economy and the banking industry. In addition, a monetary policy reporting system, accomplished through hearings, was made a matter of legislative mandate in the Federal Reserve Reform Act of 1977 (P.L. 95-188). The process was modified by provisions embodied in P.L. 95-523, the Humphrey-Hawkins Act of 1978. The provisions are designed to enhance the dialogue on monetary policy between Congress and the Federal Reserve through a more detailed reporting and evaluation process than existed earlier. Further, the provisions are intended to contribute to the ability of Congress to take a coordinated look at government economic policies. The two goals are sought through a system of regularly scheduled oversight hearings at which the Federal Reserve reports to the banking committees on its policy intention. The banking committees in turn report to their respective chambers.

The statutory requirements for semi-annual monetary policy reporting, the board's annual report and several other reports would have been discontinued by provisions of the 1995 Federal Reports Elimination and Sunset Act (P.L. 104-66). Provisions contained in P.L. 106-569, enacted on December 27, 2000, reinstated these requirements.

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<sup>11</sup> Provisions of P.L. 111-203 expand the GAO's audit authority. Please see the "Congressional Action" section of this report.



## Congressional Action

P.L. 111-203, the Dodd-Frank Wall Street Reform and Consumer Protection Act, was enacted on July 21, 2010. The omnibus financial regulatory reform law contains provisions that change the supervisory authority of the Federal Reserve Board and affect the operations and structure of Federal Reserve Board and the 12 Reserve Banks.<sup>12</sup>

Currently, the Federal Reserve Board has the primary responsibility for supervising and regulating bank holding companies and state-chartered banks that are members of the Federal Reserve System. Under the provisions of P.L. 111-203, the Federal Reserve will now regulate both bank and thrift (savings and loan) holding companies. The Federal Reserve will continue to regulate state-chartered banks that are members of the Federal Reserve System. In addition, the law authorizes the Federal Reserve to regulate systemically significant firms identified by the Financial Stability Oversight Council (provisions in P.L. 111-203 create this new council).

P.L. 111-203 establishes a second vice chairman position for the Board of Governors. A member of the board would be designated by the President, with the advice and consent of the Senate, to serve as vice chairman for supervision. The duties of this vice chairman would include developing policy recommendations regarding supervision and regulation for the board. The vice chairman of supervision will report to Congress semiannually on the efforts of the board with respect to the conduct of supervision and regulation.

The law contains additional oversight and disclosure provisions with the intent of increasing the transparency of Federal Reserve operations. Included is a required GAO audit of all of the 13(3) emergency lending by the Federal Reserve during the recent financial crisis and the authority for future GAO audits of 13(3) emergency lending, discount window lending, and open market transactions. Provisions delay disclosure of the identity of borrowers and the terms of loans.

P.L. 111-203 changes the procedures for choosing the Federal Reserve Bank presidents. As was described above, each Federal Reserve Bank is managed by a nine-member board of directors that is divided into three classes: A, B, and C. Class A and Class B directors are elected by the member banks in each district. The three Class C directors are appointed by the Board of Governors. The three Class A directors represent the interests of the member banks and the remaining six directors represent the general public. Currently, Reserve Bank presidents are appointed by the nine directors. Under P.L. 111-203, Class A directors will no longer vote for Reserve Bank presidents. In addition, the law requires the GAO to conduct a study of the current system for appointing directors to examine whether the system effectively represents the general public.

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<sup>12</sup> For an in depth discussion of the major provisions in P.L. 111-203 involving the Federal Reserve System, see CRS Report R41384, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Systemic Risk and the Federal Reserve*, by Marc Labonte and CRS Report R41339, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Titles III and VI, Regulation of Depository Institutions and Depository Institution Holding Companies*, by M. Maureen Murphy.

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